AD-F5D1 781

Copy 29 of 29 copies

AD-A257 263

IDA DOCUMENT D-1225

FREE TRADE AGREEMENTS: NORTH AMERICA AND THE NORTHWEST PACIFIC

James P. Bell

September 1992

92-29225

INSTITUTE FOR DEFENSE ANALYSES
1801 N. Beauregard Street, Alexandria, Virginia 22311-1772

IDA Log No. HQ 92-42614

DEFINITIONS

IDA publishes the following documents to report the results of its work.

Reports

Reports are the most authoritative and most carefully considered products IDA publishes. They normally embody results of major projects which (a) have a direct bearing on decisions affecting major programs, (b) address issues of significant concern to the Executive Branch, the Congress and/or the public, or (c) address issues that have significant economic implications. IDA Reports are reviewed by outside panels of experts to ensure their high quality and relevance to the problems studied, and they are released by the President of IDA.

Group Reports

Group Reports record the findings and results of IDA established working groups and panels composed of senior individuals addressing major issues which otherwise would be the subject of an IDA Report. IDA Group Reports are reviewed by the senior individuals responsible for the project and others as selected by IDA to ensure their high quality and relevance to the problems studied, and are released by the President of IDA.

Papers

Papers, also authoritative and carefully considered products of IDA, address studies that are narrower in scope than those covered in Reports. IDA Papers are reviewed to ensure that they meet the high standards expected of refereed papers in professional journals or formal Agency reports.

Documents

IDA Documents are used for the convenience of the sponsors or the analysts (a) to record substantive work done in quick reaction studies, (b) to record the proceedings of conferences and meetings, (c) to make available preliminary and tentative results of analyses, (d) to record data developed in the course of an investigation, or (e) to forward information that is essentially unanalyzed and unevaluated. The review of IDA Documents is suited to their content and intended use.

REPORT DOCUMENTATION PAGE			Form Approved OMB No. 0704-0188

1. AGENCY USE ONLY *(Leave blank)*	2. REPORT DATE September 1992	3. REPORT TYPE AND DATES COVERED

4. TITLE AND SUBTITLE
Free-Trade Agreements: North America and the Northwest Pacific

5. FUNDING NUMBERS
Central Research

6. AUTHOR(S)
Bell, James P.

7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES)
Institute for Defense Analyses
1801 N. Beauregard Street
Alexandria, VA 22311

8. PERFORMING ORGANIZATION REPORT NUMBER
IDA Document D-1225

9. SPONSORING/MONITORING AGENCY NAME(S) AND ADDRESS(ES)
Institute for Defense Analyses
1801 N. Beauregard Street
Alexandria, VA 22311

10. SPONSORING/MONITORING AGENCY REPORT NUMBER

11. SUPPLEMENTARY NOTES

12a. DISTRIBUTION/AVAILABILITY STATEMENT
Approved for public release; distribution unlimited.

12b. DISTRIBUTION CODE

13. ABSTRACT *(Maximum 200 words)*
This paper was presented at the Conference on Economic Development and Security of the Northwest Pacific Region, March 23 through 25, 1992, in Beijing, China. The conference was co-sponsored by John Endicott, Director of the Center for International Strategy, Technology, and Policy at the Georgia Institute of Technology and by Tong Dalin, Director of the Institute of Global Concern in China.

14. SUBJECT TERMS
Free-Trade Agreements, U.S.-Canada Free-Trade Agreement, North American Free-Trade Agreement, Northwest Pacific Free-Trade Agreement

15. NUMBER OF PAGES
10

16. PRICE CODE

17. SECURITY CLASSIFICATION OF REPORT	18. SECURITY CLASSIFICATION OF THIS PAGE	19. SECURITY CLASSIFICATION OF ABSTRACT	20. LIMITATION OF ABSTRACT
Unclassified	Unclassified	Unclassified	UL

IDA DOCUMENT D-1225

FREE TRADE AGREEMENTS: NORTH AMERICA AND THE NORTHWEST PACIFIC

James P. Bell

September 1992

IDA

INSTITUTE FOR DEFENSE ANALYSES

IDA Central Research Program

PREFACE

This paper was presented at the Conference on Economic Development and Security of the Northwest Pacific Region, March 23 through 25, 1992, in Beijing China. The conference was co-sponsored by John Endicott, Director of the Center for International Strategy, Technology, and Policy at the Georgia Institute of Technology and by Tong Dalin, Director of the Institute of Global Concern in China. Funding for the paper was provided by the Institute for Defense Analyses under its Central Research Program.

TABLE OF CONTENTS

FREE-TRADE AGREEMENTS: NORTH AMERICA AND THE NORTHWEST PACIFIC

The U.S., Canada, and Mexico are negotiating a North American Free-Trade Agreement (NAFTA). Would such an agreement pose a threat to the countries of the Northwest Pacific? Should they establish their own Northwest Pacific Free-Trade Agreement (NWPFTA)?

The answer to the first question is no. A NAFTA would be designed to liberalize trade within North America, not to protect North America from global competition. Secretary of State James Baker recently said:

> ...the emerging North American Free Trade Area will support both APEC [Asia-Pacific Economic Cooperation] and the global, multilateral systems for trade and financial flows. ... Growth will bring expanding markets for Asian traders and investors, thus strengthening, not weakening, trans-Pacific economic links. (Baker, p. 7)

The answer to the second question is less clear. A NWPFTA could greatly increase the productivity of the region. However, the political and economic prerequisites for a successful NWPFTA may not yet exist.

FREE-TRADE AGREEMENTS AND THE GATT

First, let us take a closer look at free-trade agreements (FTAs). There is a lot of confusion in the popular press about what FTAs are designed to accomplish. Some writers think the world is being divided into protectionist blocs, like so many European empires in the eighteenth century.

FTAs are preferential agreements. They lower trade barriers among the partners and create new trade. They raise productivity through increased competition and specialization among insiders. At the same time, FTAs discriminate against outsiders. Their products do not receive preferential treatment. Imports may be diverted from outside to inside sources.

The net impact of an FTA on outsiders depends on its provisions. While discrimination may retard their sales, outsiders may benefit from the creation of a larger, more prosperous FTA market. Further, the impact of discrimination may be neutralized by negotiations to lower trade barriers between FTA partners and outsiders. For example, previous expansions of the European Community have been accompanied by successful negotiations to lower global trade barriers under the General Agreement on Tariffs and Trade (GATT). Success in the Uruguay Round of GATT negotiations would help offset the discrimination inherent in a NAFTA.

On the other hand, there is a danger that preferential trade agreements will be captured by special interests that want to promote discrimination against outsiders. They may seek to raise external barriers in order to gain competitive advantages. Proliferation of such agreements would invite retaliation and trade wars, and could lead to a breakdown of the global trading system.

The GATT generally frowns on preferential trade agreements and instead requires nondiscriminatory, most-favored-nation treatment. However, the GATT does recognize that FTAs could be beneficial in some cases. Article XXIV specifies the criteria that FTAs must satisfy. They must apply to substantially all of the trade between the member countries, they must be fully implemented within a reasonable period of time, and they may not raise barriers to trade with nonmember countries.

To satisfy these criteria, the partners must make a serious commitment to free trade. Preferential agreements designed primarily to divert trade from outsiders would not be acceptable. The creation of exclusive trade blocs with prohibitive external barriers would be even less acceptable.

So long as FTAs are negotiated in the context of a continuing commitment to the GATT, they do not represent a serious threat to the global trade system. They may put outsiders at a competitive disadvantage but they do not presage the division of the world into exclusive blocs.

THE U.S.-CANADA FREE-TRADE AGREEMENT (UCFTA)

The U.S.-Canada Free-Trade Agreement (UCFTA), which took effect in 1989, satisfies the GATT requirements. Over a period of 10 years, the UCFTA will eliminate virtually all tariffs on trade between the U.S. and Canada. It prohibits most new nontariff barriers, although it allows most existing barriers to remain (e.g., in agriculture). It establishes mechanisms to settle trade disputes and limit the use of unfair trade laws to protect domestic industries.

Most importantly, the UCFTA does not raise new barriers to trade with nonmember countries. The U.S. and Canada remain free to establish their own trade policies affecting other countries. Unlike the European Community, the UCFTA makes no attempt to establish a common tariff wall.

The primary effect of the UCFTA will be to create new trade between the U.S. and Canada. These countries will buy from each other things that they now make for themselves. Specialization will increase productivity and the U.S. and Canada will become stronger global competitors.

The UCFTA will have both disadvantages and advantages for Asian countries. On the negative side, the reduction in tariffs and other import barriers will not apply to items produced in nonmember countries. This will give the U.S. and Canada a competitive advantage in selling to each other's markets. On the positive side, Asian investors that own factories in the U.S. and Canada will be able to sell to the larger U.S.-Canada market. New factories cannot be required to export part of production or purchase parts locally. Further, the competitive position of Asian exporters will be improved by the prohibition of export subsidies in U.S.-Canada trade.

Asian exporters may also benefit from UCFTA provisions to discipline the use of unfair trade laws. These laws are designed to protect domestic industries against imports that are subsidized by foreign governments or sold below cost. In practice, unfair trade laws are often used to create barriers against trade that is fair. Indeed, this is one of the most important ways in which new barriers have been established in recent years. The UCFTA establishes a binding appeal process to prevent the improper use of these laws in particular cases. As abuses are documented, we can expect an improvement in enforcement procedures. Although the appeal process applies only to U.S.-Canadian trade, improved procedures should benefit all trading partners.

Eventually, the UCFTA will improve the prospects for multilateral trade liberalization. For example, in the short run, the UCFTA will force protected industries in the U.S. and Canada to compete with one another. Inefficient firms will be forced to adjust or shut down. The survivors will be efficient. One way or the other, the need for protection will be reduced.

A NORTH AMERICAN FREE-TRADE AGREEMENT (NAFTA)

The U.S., Canada, and Mexico initiated negotiations in 1991 to establish a North American Free-Trade Agreement (NAFTA). Like the UCFTA, a NAFTA would be consistent with GATT principles and would not raise barriers to trade with nonmember countries.

The prospect of a NAFTA is interesting because it would join the U.S. and Canada with a country that is very different both economically and culturally. This situation closely parallels the case of the Northwest Pacific, where a free-trade agreement would link the advanced Japanese economy with its very different neighbors.

NAFTA negotiators must face some difficult issues. Economic development in Mexico is at a much lower level than in the U.S. and Canada. In 1989, Mexican wages were only 15% of the U.S. level. With free trade, labor-intensive industries in the U.S. and Canada would have great difficulty competing. Many companies would shut down or move to Mexico.

At the same time, Mexico has a long tradition of protecting and supporting inefficient domestic industries. Very few Mexican industries are now capable of standing up to world class competition. Under free trade, many of these industries would be overwhelmed by their more efficient counterparts in the U.S. and Canada. Many companies would shut down.

Mexico's policy of targeting higher-technology industries for development has succeeded in generating exports of automotive and computer products. Under this policy, foreign companies have been allowed to sell in Mexico only if they established Mexican factories and exported part of the output. However, under free trade, U.S. and Canadian companies would be able to sell in Mexico without building factories there. Free trade would hurt Mexico's ability to promote high-technology industries.

A NAFTA would require painful adjustments in the U.S., Canada, and Mexico. While the long-run productivity improvements would be substantial, short-run political and economic costs would limit the pace and amount of trade liberalization. It is by no means certain that negotiations will succeed.

Nevertheless, some important preconditions for a successful agreement are already in place. Most importantly, Mexico has reversed its longstanding traditions and committed itself to free trade. Unilaterally, Mexico has reduced tariffs and eliminated most import licensing requirements. It is privatizing government-owned industries and liberalizing domestic regulations. Foreign investment is now welcomed in most industries.

Incidentally, Mexico has joined the GATT and is liberalizing on a multilateral basis. Now that Mexico is joining the world economy, it would not be interested in a NAFTA that closed North America to global competition.

The chances for a NAFTA are also improved because labor-intensive industries in the U.S. have already faced substantial competition from Mexico in recent years. The U.S. market is already relatively open for most products. Further, under the maquiladora program, U.S.-made components are assembled in Mexico and the resulting products receive favorable tariff treatment when they are shipped back to the U.S. As a result, U.S. factories making automotive parts, electronic products, and garments have already had to adjust to Mexican competition.

Finally, the U.S. has a strong political interest in the prosperity and stability of Mexico. A NAFTA would commit Mexico to continue the liberal economic policies that can create prosperity.

IMPACT OF A NAFTA ON THE NORTHWEST PACIFIC

With or without a NAFTA, Mexico has the potential to become a strong competitor to the economies in South Korea, Taiwan, and Hong Kong. Mexico has major advantages in its low-cost labor, its geographic proximity to the U.S., and its abundant natural resources. Now that Mexico is opening its economy and welcoming foreign investment, it can capitalize on these advantages.

Nevertheless, Mexico is not a competitive threat today. It will need time to upgrade its infrastructure, train its work force, and develop efficient export industries. Mexico cannot compete on the basis of cheap labor alone; its wage levels are somewhat lower than those of South Korea, Taiwan, and Hong Kong but substantially higher than those of China, Indonesia, and Bangladesh.

Generally, U.S. import tariffs are so low that eliminating them for Mexican products would not put Asian economies at a serious disadvantage. However, NAFTA treatment of nontariff barriers could hurt Asian exports, particularly for textiles and automotive parts.

For example, textile and apparel imports from most developing countries are now restricted by import quotas under the multi-fiber agreement (MFA). The U.S. wishes to phase out the MFA quotas for all countries under the Uruguay Round of GATT negotiations. However, it is possible that the Uruguay Round will not phase out the MFA but that a NAFTA will phase out U.S. quotas on Mexican textiles. This would give Mexico a significant advantage and would encourage investment to make Mexico's industry competitive. To some extent, generous quotas and the maquiladora program have already given Mexico an advantage here.

In addition, strong rules of origin under a NAFTA would give Mexican auto parts a competitive advantage. The UCFTA provides duty-free treatment to automobiles only if at least 50 percent of their direct costs originate in the U.S. and Canada. Under a NAFTA, there is considerable pressure to make this rule even stronger. Mexican parts supplied to transplant factories would qualify as North American inputs, while Asian parts would not. Mexico has already become an important supplier of parts to U.S.-owned factories.

NAFTA provisions such as these would give Mexico a competitive advantage in attracting investment. However, during the past 10 years, Mexico already was the recipient of more foreign direct investment than any other developing country, receiving 13.8 percent of the total.

Overall, we should expect a NAFTA to reinforce existing trends. Some Asian exports would be hurt, most would not be affected, and some would increase.

A NORTHWEST PACIFIC FREE-TRADE AGREEMENT (NWPFTA)

The most effective global response to a NAFTA would be successful completion of the Uruguay Round. This would minimize the discriminatory impact of a NAFTA and preserve the open global trade system. Continuing trade negotiations between Asian economies and the U.S. are also important. In some cases, FTAs among Asian economies might be beneficial on their own merits.

A Northwest Pacific Free-Trade Agreement (NWPFTA) would raise many of the same issues as a NAFTA. Labor-intensive industries in Japan would face stiff competition from their counterparts in South Korea, Taiwan, and Hong Kong. In turn, South Korea, Taiwan, and Hong Kong would face low-wage competitors in China and North Korea.

Japan could not be expected to open its markets for labor-intensive products unless the other members opened their economies to Japan's high-technology goods. However, Japan is so strong in these areas that it would overwhelm its competitors in many sectors.

Producers of high-technology goods in other member countries would demand access to Japanese markets. However, Japanese markets are tightly organized and difficult to penetrate. Government-to-government agreements could clear away only some of the obstacles.

All of the countries of the Northwest Pacific have aspirations to develop high-technology industries and to preserve national autonomy. These aspirations are based in part on security requirements. They cannot be bargained away until regional stability has matured. The situation is different in North America. The U.S. and Canada are NATO allies and Mexico has decided that it can no longer afford autonomy.

A NWPFTA may be premature at this time. Political relations must deepen to reduce concerns about autonomy. The less advanced countries need time to develop high-technology industries that can compete with their counterparts in Japan. Free trade now would increase regional productivity in a narrow economic sense but member governments would not like the way markets allocated industries.

CONCLUSION

Let us conclude by listing some possible prerequisites for establishing successful free-trade agreements.

First, it helps if the partners' economies are already relatively open, with trade policies consistent with the GATT. This forces domestic industries to prepare for free trade. If the partners are not prepared, an agreement would probably be weak.

Second, internal political stability is important. Implementing free trade is a long, painful, and often unpopular process, particularly if the partners are not well prepared.

Third, relations among the partners should be friendly and stable. Free trade will create strong and unpredictable interdependencies. Some national aspirations will be frustrated.

Fourth, strong geopolitical motivations and leadership are useful. These can strengthen efforts to reach an agreement and encourage partners to accept unequal concessions when necessary.

Fifth, some commonality in economic methods and legal institutions is important. Otherwise, market-oriented free trade is not possible.

When these conditions are not satisified, there is a danger that negotiators will raise external trade barriers to compensate for lowering regional barriers. Such actions would put the global trading system at risk. However, the UCFTA demonstrates the feasibility of a regional FTA that is consistent with the GATT regime.

REFERENCES

Baker, James A.,III, "America in Asia: Emerging Architecture for a Pacific Community," *Foreign Affairs*, Winter 1991/92, Vol.70, No. 5.

Bello, Walden and Rosenfeld, Stephanie, *Dragons in Distress*, Institute for Food and Development Policy, San Francisco, 1990.

Bergsten, C. Fred, "Commentary: The Move Toward Free-Trade Zones," in *Policy Implications of Trade and Currency Zones*, The Federal Reserve Bank of Kansas City, 1991.

Bhagwati, Jagdish, *The World Trading System at Risk*, Princeton University Press, 1991.

Change, Interdependence and Security in the Pacific Basin, Edited by Dora Alves, National Defense University Press, Washington D.C., 1991.

Completing the Uruguay Round, Edited by Jeffrey J. Schott, Institute for International Economics, Washington D.C., 1990.

Economic Opportunities in Freer U.S. Trade with Canada, Edited by Fredric C. Menz and Sarah A. Stevens, State University of New York Press, 1991.

Free Trade Areas and U.S. Trade Policy, Edited by Jeffrey J. Schott, Institute for International Economics, Washington D.C., 1989.

Krugman, Paul, "The Move Toward Free Trade Zones," in *Policy Implications of Trade and Currency Zones*, The Federal Reserve Bank of Kansas City, 1991.

Morici, Peter, *Trade Talks with Mexico: a Time for Realism,* National Planning Association, Washington D.C., 1991.

Noland, Marcus, *Pacific Basin Developing Countries*, Institute for International Economics, Washington D.C. 1990.

Toward a North American Common Market, Edited by Charles F. Bonser, Westview Press, 1989.

U.S.-Mexican Industrial Integration, Edited by Sidney Weintraub, Westview Press, 1991.